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TAGS: ECON EFIN EAGR WTRO CH JP
SUBJECT: BANK OF JAPAN REPRESENTATIVE'S CONCERNS ABOUT CHINA'S
CURRENCY AND MONETARY POLICY CHALLENGES

SUMMARY

¶1. (SBU) The Bank of Japan (BOJ) Chief Representative to China, Kiyoyuki Seguchi, said that BOJ is concerned that China's large balance of payments surplus and rigid exchange rate are contributing to excess liquidity, over-investment, and asset bubbles in real estate and stocks, increasing the risk of a boom/bust cycle. To maintain financial and price stability, the People's Bank of China (PBOC) might be forced to slam on the brakes, sharply limiting lending and making it difficult for borrowers to roll over debt. China should avoid such a scenario by tightening monetary policy now. Seguchi said that the PBOC understands the need for renminbi (RMB) appreciation but is politically constrained by concerns about the adverse impact on: (1) agricultural competitiveness, given the rapid rise in imports due to implementation ofChina's WTO commitments; and (2) processing sctor (export assmbly) jobs. He said that a 10-20 percent short-term RMB appreciation would cause numerous marginal low-end producers to close factories in China, noting that the sectors they represent (e.g., textiles) are particularly labor intensive. END SUMMARY

VIEWS ON CURRENCY AND MONETARY POLICY

¶2. (SBU) Seguchi recently told Finatt and Econoff that the BOJ's views on renminbi (RMB) valuation are very close to those of the United States Treasury. He said that the BOJ is concerned that a large balance of payments surplus and a rigid exchange rate are contributing to excess liquidity, over-investment, and asset bubbles in real estate and stocks, increasing the risk of a boom/bust cycle. To maintain financial and price stability, the PBOC might be forced to slam on the brakes, sharply limiting lending and making it difficult for borrowers to roll over debt.

¶3. (SBU) In Seguchi's view, China should avoid such a scenario by tightening monetary policy now. Even though corporate investment is increasingly financed through retained earnings, there remains a relatively tight link between credit and investment growth, so constraining the former will constrain the latter.

WHAT CHINA SHOULD DO

¶4. (SBU) Seguchi said that the PBOC understands the need for RMB appreciation but is politically constrained by concerns about the adverse impact on: (1) agricultural competitiveness, given the rapid rise in imports due to implementation of China's WTO commitments; and (2) processing (export assembly) jobs. Seguchi said that a

10-20 percent short-term RMB appreciation would cause numerous marginal low-end producers to close factories in China, and the sectors they represent (e.g., textiles) are particularly labor intensive.

¶5. (SBU) As for interest rates, Seguchi believes that Chinese monetary officials are reluctant to raise deposit rates because of their concern that banks' inability to assess and manage credit risk would continue to lead to a high level of non-performing loans. As a result, monetary authorities want to maintain a large intermediation spread to generate sufficient income to provision for bad loans.

JAPANESE INVESTMENT IN CHINESE BANKS

¶6. (SBU) Seguchi observed that Japanese banks still remain cautious about investing in Chinese banks given the large losses they incurred investing in local government international trade and investment corporations (ITICs) in previous years that subsequently went bankrupt. The "China hands" who populated Japan's banks at that time are now key decision makers, tarnished by this experience of learning the hard way that government backing could not be taken for granted.

LEARNING FROM JAPAN'S EXPERIENCE

¶7. (SBU) Finatt explained how Chinese officials argue that the lesson they draw from Japan's experience in the 1980s is not to concede to foreign pressure to let the exchange rate appreciate since, in these officials' views, this led to a decade of deflation and ultimately had little impact on external imbalances. Seguchi responded that rather than avoiding Japan's mistakes, China risks repeating them. With an open economy, China is unlikely to

experience high inflation in goods from an undervalued currency and excessively loose monetary policy, but will experience asset bubbles just like Japan. Seguchi said that he has communicated to the PBOC the importance of understanding Japan's "failure" in the 1980s, i.e., Japan over-estimated the impact of currency appreciation on monetary conditions, thereby easing monetary policy too much, leading to asset bubbles and their subsequent bust and the "lost decade" of the 1990s.

REACHING OUT

¶8. (SBU) Finatt urged BOJ officials (both current and former) to broaden channels for explaining the lessons of Japan's experience to China, since they would be the most credible interlocutors on this issue. Seguchi responded that two officials might be particularly effective: (1) BOJ Deputy Governor Horii, and (2) Yasuhisa Shiozaki in the Cabinet Office. Seguchi subsequently spoke with Horii who suggested that he and Treasury Under Secretary Adams discuss this before Horii comes to China later in the year.

RANDT